UBS

Monthly Letter: Weather report

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In markets, it can be easy to get lost in the details and miss some of the bigger trends. In our latest monthly letter, we discuss the key opportunities for investors as inflation falls, AI investment booms, and the global equity rally broadens.

"You don't need a weatherman to know which way the wind blows." Bob Dylan

Sometimes it can be all too easy to get lost in the details and miss some of the big trends that are impacting markets:

- Inflation is falling and interest rates are already being cut in some countries
- AI-related capital investment is booming
- The equity market rally has broadened globally
- The US election is approaching, and both the result and potential implications are uncertain

What do they mean for investors?

First, lower inflation and lower interest rates should support stocks and bonds. Higher interest rates have led many investors to hold more cash or money market investments than usual. Lower interest rates will likely lead at least some of that money to a new home. Fixed income is a natural destination, while carry strategies using currencies are likely to rise in appeal. We also expect stocks to benefit, especially if the US economy achieves the soft landing we envision.

Second, we think increasing investment in artificial intelligence capabilities by technology firms will contribute to significant profit growth in the "enabling layer" of the AI value chain—notably in the semiconductor industry. Eventually, artificial intelligence should lead to value creation across a broad range of industries and applications. For now, we see "AI enablers" as the most tangible and profitable opportunity for investors.

Third, the broadening of the equity market rally—both in terms of earnings and performance—should widen the opportunity set for investors looking to diversify sources of return beyond technology.

Finally, investors need to be cognizant of the potential for political and geopolitical risks to drive volatility and impact markets as the year progresses.

How to position?

Fixed income remains our preferred asset class, within which we favor quality bonds. We expect quality bond yields to fall in the months ahead as markets start to price a more convincing central bank rate-cutting cycle. Complementing a core holding in quality bonds with a satellite in riskier credits can improve overall portfolio yields. Decent economic growth means default rates are likely to remain contained, even if spreads are tight.

In equities, we see modest upside overall, and focus on capital preservation strategies and selectivity. In technology, positioning for upside via options or structures can be an effective way to manage sentiment, valuation, and idiosyncratic risks. At an index level, such strategies can also help investors mitigate potential policy and geopolitical risks. Looking beyond tech, we like exposure to some more lowly valued parts of the equity universe, including the UK market and US small-caps.

Read more in the latest Monthly Letter, "Weather report," and watch a short video here.

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